

Executive Officers of the Registrant  
(as of March 25, 1998)

Name	Age		Became AT&T Executive Officer On
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C. Michael Armstrong*	59	Chairman of the Board and Chief Executive Officer . . . . .	10-97
R.C.M. Baker . . . . .	51	Executive Vice President, International . . . . .	9-97
Harry S. Bennett . . . . .	53	Executive Vice President, Local Services Division . . . . .	3-97
Harold W. Burlingame . . . . .	57	Executive Vice President, Human Resources . . . . .	9-86
Dan R. Hesse . . . . .	44	Executive Vice President & President, AT&T Wireless Services . . . . .	3-97
Frank Ianna . . . . .	48	Executive Vice President, Network & Computing Services . . . . .	3-97
Jim G. Kilpatric*** . . . . .	59	Executive Vice President, Law & Government Affairs . . . . .	11-97
Marilyn Laurie*** . . . . .	58	Executive Vice President, Brand Strategy & Marketing Communications . . . . .	2-87
Richard J. Martin . . . . .	51	Executive Vice President, Public Relations . . . . .	11-97
Gail J. McGovern . . . . .	45	Executive Vice President, Consumer Markets Division . . . . .	1-96
David C. Nagel . . . . .	53	President, AT&T Labs & Chief Technology Officer . . . . .	3-97
John C. Petrillo . . . . .	48	Executive Vice President, Corporate Strategy & Business Development . . . . .	1-96
Richard Roscitt . . . . .	46	Executive Vice President & President, AT&T Solutions . . . . .	9-97
Daniel E. Somers . . . . .	50	Senior Executive Vice President and Chief Financial Officer . . . . .	5-97
John D. Zeglis** . . . . .	50	President . . . . .	9-86

\*Chairman of the Board of Directors and Chairman of the Executive  
and Proxy Committees.

\*\*Member of the Board of Directors.

\*\*\*Mr. Kilpatric and Ms. Laurie will retire from the Company in April 1998.

All of the above executive officers have held high level managerial positions with AT&T or its affiliates for more than the past five years, except Messrs. Armstrong, Nagel and Somers. Prior to joining AT&T in October 1997, Mr. Armstrong was Chairman and Chief Executive Officer of Hughes Electronics from 1991 and prior to that time, Mr. Armstrong held various other positions with IBM, including Senior Vice President and Chairman of the board of IBM World Trade Corporation. Prior to joining AT&T in April 1996, Mr. Nagel was with Apple Computer, a computer company, serving as Senior Vice President from 1995 and General Manager from 1988 through 1995. Prior to joining AT&T in May 1997, Mr. Somers was Chairman and Chief Executive Officer for Bell Cablemedia, plc, of London for two years and from 1992 to 1995, Mr. Somers was Executive Vice President and Chief Financial Officer for Bell Canada International.

PART II

Items 5. through 8.

The information required by these items is included in pages 25 through 56 of the Company's annual report to shareholders for the year ended December 31, 1997. Such information is incorporated herein by reference, pursuant to General Instruction G(2). The referenced information from the Company's annual report to shareholders has been filed as Exhibit 13 to this document.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

There have been no changes in independent accountants and no disagreements with independent accountants on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure during the last two years.

PART III

Items 10. through 13.

Information regarding executive officers required by Item 401 of Regulation S-K is furnished in a separate disclosure in Part I of this report because the Company did not furnish such information in its definitive proxy statement prepared in accordance with Schedule 14A.

The other information required by Items 10 through 13 is included in the Company's definitive proxy statement dated March 26, 1998, the third and fourth paragraphs on page 6, the carryover paragraph on page 7, the first, second and third full paragraphs on page 7, the second full paragraph on page 8 through the final footnote on page 13 and the last paragraph on page 23 through page 48. Such information is incorporated herein by reference, pursuant to General Instruction G(3).

PART IV

Item 14. Exhibits, Financial Statement Schedule, and Reports on Form 8-K.

(a) Documents filed as a part of the report:

(1) Financial Statements:

	Pages -----
Report of Management .....	*
Report of Independent Accountants .....	*
Statements:	
Consolidated Statements of Income .....	*
Consolidated Balance Sheets .....	*
Consolidated Statements of Changes in Shareowners' Equity .....	*
Consolidated Statements of Cash Flows .....	*
Notes to Consolidated Financial Statements .....	*

(2) Financial Statement Schedule:

Report of Independent Accountants .....	18
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Schedule:

II -- Valuation and Qualifying Accounts .....	19
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Separate financial statements of subsidiaries not consolidated and 50 percent or less owned persons are omitted since no such entity constitutes a "significant subsidiary" pursuant to the provisions of Regulation S-X, Article 3-9.

(3) Exhibits:

Exhibits identified in parentheses below, on file with the Securities and Exchange Commission ("SEC"), are incorporated herein by reference as exhibits hereto.

Exhibit  
Number:

- (3)a Restated Certificate of Incorporation of the registrant filed January 10, 1989, Certificate of Correction of the registrant filed June 8, 1989, Certificate of Change of the registrant filed March 18, 1992, Certificate of Amendment of the registrant filed June 1, 1992, and Certificate of Amendment of the registrant filed April 20, 1994. (Exhibit 4 to Registration Statement No. 333-00573).

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\*Incorporated herein by reference to the appropriate portions of the Company's annual report to shareholders for the year ended December 31, 1997. (See Part II.)

- (3)b By-Laws of the registrant, as amended January 15, 1997 (Exhibit (3)b to Form 10-K for 1996, File No. 1-1105).
- (4) No instrument which defines the rights of holders of long term debt, of the registrant and all of its consolidated subsidiaries, is filed herewith pursuant to Regulation S-K, Item 601(b)(4)(iii)(A). Pursuant to this regulation, the registrant hereby agrees to furnish a copy of any such instrument to the SEC upon request.
- (10)(i)1 Form of Separation and Distribution Agreement by and among AT&T Corp., Lucent Technologies Inc. and NCR Corporation, dated as of February 1, 1996 and amended and restated as of March 29, 1996 (Exhibit (10)(i)1 to Form 10-K for 1996, File No. 1-1105).
- (10)(i)2 Form of Distribution Agreement, dated as of November 20, 1996, by and between AT&T Corp. and NCR Corporation (Exhibit (10)(i)2 to Form 10-K for 1996, File No. 1-1105).
- (10)(i)3 Tax Sharing Agreement by and among AT&T Corp., Lucent Technologies Inc. and NCR Corporation, dated as of February 1, 1996 and amended and restated as of March 29, 1996 (Exhibit (10)(i)3 to Form 10-K for 1996, File No. 1-1105).
- (10)(i)4 Employee Benefits Agreement by and between AT&T Corp. and Lucent Technologies Inc., dated as of February 1, 1996 and amended and restated as of March 29, 1996 (Exhibit (10)(i)4 to Form 10-K for 1996, File No. 1-1105).
- (10)(i)5 Form of Employee Benefits Agreement, dated as of November 20, 1996, between AT&T Corp. and NCR Corporation (Exhibit (10)(i)5 to Form 10-K for 1996, File No. 1-1105).
- (10)(ii)(B)1 General Purchase Agreement between AT&T Corp. and Lucent Technologies Inc., dated February 1, 1996 and amended and restated as of March 29, 1996 (Exhibit (10)(ii)(B)1 to Form 10-K for 1996, File No. 1-1105).
- (10)(ii)(B)2 Form of Volume Purchase Agreement, dated as of November 20, 1996, by and between AT&T Corp. and NCR Corporation (Exhibit (10)(ii)(B)2 to Form 10-K for 1996, File No. 1-1105).
- (10)(iii)(A)1 AT&T Short Term Incentive Plan as amended March, 1994 (Exhibit (10)(iii)(A)1 to Form 10-K for 1994, File No. 1-1105).
- (10)(iii)(A)2 AT&T 1987 Long Term Incentive Program as amended December 17, 1997.
- (10)(iii)(A)3 AT&T Senior Management Individual Life Insurance Program as amended March 3, 1998.
- (10)(iii)(A)4 AT&T Senior Management Long Term Disability and Survivor Protection Plan, as amended and restated effective January 1, 1995 (Exhibit (10)(iii)(A)4 to Form 10-K for 1996, File No. 1-1105).
- (10)(iii)(A)5 AT&T Senior Management Financial Counseling Program dated December 29, 1994 (Exhibit (10)(iii)(A)5 to Form 10-K for 1994, File No. 1-1105).

- (10) (iii) (A) 6 AT&T Deferred Compensation Plan for Non-Employee Directors, as amended December 15, 1993 (Exhibit (10) (iii) (A) 6 to Form 10-K for 1993, File No. 1-1105).
- (10) (iii) (A) 7 The AT&T Directors Individual Life Insurance Program as amended March 2, 1998.
- (10) (iii) (A) 8 AT&T Plan for Non-Employee Directors' Travel Accident Insurance (Exhibit (10) (iii) (A) 8 to Form 10-K for 1990, File No. 1-1105).
- (10) (iii) (A) 9 AT&T Excess Benefit and Compensation Plan, as amended and restated effective October 1, 1996 (Exhibit (10) (iii) (A) 9 to Form 10-K for 1996, File No. 1-1105).
- (10) (iii) (A) 10 AT&T Non-Qualified Pension Plan, as amended and restated January 1, 1995 (Exhibit (10) (iii) (A) 10 to Form 10-K for 1996, File No. 1-1105).
- (10) (iii) (A) 11 AT&T Senior Management Incentive Award Deferral Plan, as amended December 17, 1997.
- (10) (iii) (A) 12 AT&T Mid-Career Hire Program revised effective January 1, 1988 (Exhibit (10) (iii) (A) 4 to Form SE, dated March 25, 1988, File No. 1-1105) including AT&T Mid-Career Pension Plan, as amended and restated October 1, 1996, (Exhibit (10) (iii) (A) 12 to Form 10-K for 1996, File No. 1-1105).
- (10) (iii) (A) 13 AT&T 1997 Long Term Incentive Program as amended December 17, 1997.
- (10) (iii) (A) 14 Form of Indemnification Contract for Officers and Directors (Exhibit (10) (iii) (A) 6 to Form SE, dated March 25, 1987, File No. 1-1105).
- (10) (iii) (A) 15 Pension Plan for AT&T Non-Employee Directors revised February 20, 1989 (Exhibit (10) (iii) (A) 15 to Form 10-K for 1993, File No. 1-1105).
- (10) (iii) (A) 16 AT&T Corp. Senior Management Basic Life Insurance Program, as amended February 27, 1998.
- (10) (iii) (A) 17 Form of AT&T Benefits Protection Trust Agreement (Exhibit (10) (iii) (A) 17 to Form SE, dated March 25, 1992, File No. 1-1105).
- (10) (iii) (A) 18 AT&T Senior Officer Severance Plan effective October 9, 1997, as amended October 30, 1997.
- (10) (iii) (A) 19 Form of Pension Agreement between AT&T Corp. and Frank Ianna dated October 30, 1997.
- (10) (iii) (A) 20 Form of Pension Agreement between AT&T Corp. and Gail J. McGovern dated October 30, 1997.
- (10) (iii) (A) 21 Form of Pension Agreement between AT&T Corp. and John C. Petrillo dated October 30, 1997.
- (10) (iii) (A) 22 Form of Pension Agreement between AT&T Corp. and John Zeglis dated May 7, 1997.

- (10)(iii)(A)23 Form of Employment Agreement between AT&T Corp. and C. Michael Armstrong dated October 17, 1997.
- (12) Computation of Ratio of Earnings to Fixed Charges.
- (13) Specified portions (pages 25 through 56) of the Company's Annual Report to Shareholders for the year ended December 31, 1997.
- (21) List of subsidiaries of AT&T.
- (23) Consent of Coopers & Lybrand L.L.P.
- (24) Powers of Attorney executed by officers and directors who signed this report.
- (27) Financial Data Schedules.

AT&T will furnish, without charge, to a shareholder upon request a copy of the annual report to shareholders and the proxy statement, portions of which are incorporated herein by reference thereto. AT&T will furnish any other exhibit at cost.

(b) Reports on Form 8-K:

During the fourth quarter 1997, Form 8-K dated October 20, 1997 was filed pursuant to Item 5 (Other Events) and Item 7 (Financial Statements and Exhibits) on October 24, 1997, Form 8-K dated October 20, 1997 was filed pursuant to Item 5 (Other Events) on November 4, 1997 and Form 8-K dated December 18, 1997 was filed pursuant to Item 2 (Acquisition or Disposition of Assets) and Item 7 (Financial Statements and Exhibits) on December 23, 1997.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Shareowners of AT&T Corp.:

Our report on the consolidated financial statements of AT&T Corp. and subsidiaries has been incorporated by reference in this Form 10-K from page 39 of the 1997 Annual Report to the Shareowners of AT&T Corp. In connection with our audits of such financial statements, we have also audited the related consolidated financial statement schedule listed in the index on page 14 of this Form 10-K.

In our opinion, the consolidated financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information required to be included therein.

COOPERS & LYBRAND L.L.P.

1301 Avenue of the Americas  
New York, New York  
January 26, 1998

Schedule II--Sheet 1

AT&T CORP.  
AND ITS CONSOLIDATED SUBSIDIARIES

SCHEDULE II--VALUATION AND QUALIFYING ACCOUNTS

(Millions of Dollars)

COL. A	COL. B	COL. C	COL. D	COL. E
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions (a)	Balance at End of Period
Year 1997				
Allowances for doubtful accounts (b) .....	\$ 994	\$1,957	\$1,925	\$1,026
Reserves related to business restructuring, including force and facility consolidation (c) .....	\$1,388	\$ --	\$ 481	\$ 907
Deferred tax asset valuation allowance ...	\$ 166	\$ 48	\$ 2	\$ 212
Year 1996				
Allowances for doubtful accounts (b) .....	\$ 832	\$1,938	\$1,776	\$ 994
Reserves related to business restructuring, including force and facility consolidation (c) .....	\$2,092	\$ --	\$ 704	\$1,388
Deferred tax asset valuation allowance ...	\$ 129	\$ 39	\$ 2	\$ 166

The Notes on Sheet 2 are an integral part of this Schedule.



Schedule II--Sheet 2

AT&T CORP.  
AND ITS CONSOLIDATED SUBSIDIARIES

SCHEDULE II--VALUATION AND QUALIFYING ACCOUNTS  
(Millions of Dollars)

COL. A	COL. B	COL. C	COL. D	COL. E
Description	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions (a)	Balance at End of Period
Year 1995				
Allowances for doubtful accounts (b) . . . . .	\$ 611	\$1,613	\$1,392	\$ 832
Reserves related to business restructuring, including force and facility consolidation (c) . . . . .	\$ 699	\$1,712	\$ 319	\$2,092
Deferred tax asset valuation allowance . . .	\$ 36	\$ 109	\$ 16	\$ 129

- (a) Amounts written off as uncollectible, net of recoveries.
- (b) Includes allowances for doubtful accounts on long-term receivables of \$49 \$52 and \$35 in 1997, 1996 and 1995, respectively (included in long-term receivables in the Consolidated Balance Sheets).
- (c) Included primarily in other current liabilities and in other long-term liabilities and deferred credits in the Consolidated Balance Sheets.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AT&T Corp.

By: M. J. Wasser  
Vice President - Law and Secretary

March 26, 1998

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Principal Executive Officers:

C. Michael Armstrong	Chairman of the Board and Chief Executive Officer
John Zeglis	President and Director

Principal Financial Officer:

Daniel E. Somers	Senior Executive Vice President and Chief Financial Officer
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Principal Accounting Officer:

Maureen B. Tart	Vice President and Controller
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By M. J. Wasser  
(attorney-in-fact)\*

March 26, 1998

Directors:

Kenneth T. Derr  
M. Kathryn Eickhoff  
Walter Y. Elisha  
George M. C. Fisher  
Donald V. Fites  
Ralph S. Larsen  
Donald F. McHenry  
Michael I. Sovern  
Thomas H. Wyman

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ J. BRUCE LLEWELLYN</u> J. Bruce Llewellyn	Director	March 6, 1998
<u>/s/ JAMES O. ROBBINS</u> James O. Robbins	Director	March 6, 1998
<u>/s/ JOHN R. ALCHIN</u> John R. Alchin	Director	March 6, 1998
<u>/s/ C. B. ROGERS, JR.</u> C. B. Rogers, Jr.	Director	March 6, 1998
<u>/s/ LARRY E. ROMRELL</u> Larry E. Romrell	Director	March 6, 1998
<u>/s/ BERNARD W. SCHOTTERS</u> Bernard W. Schotters	Director	March 6, 1998
<u>/s/ LAWRENCE S. SMITH</u> Lawrence S. Smith	Director	March 6, 1998
<u>/s/ DAVID M. WOODROW</u> David M. Woodrow	Director	March 6, 1998

## SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TELEPORT COMMUNICATIONS GROUP INC.  
(Registrant)

Date March 9, 1998

By: /s/ ROBERT ANNUNZIATA  
Robert Annunziata,  
President and Chief Executive Officer

<u>Signature</u>	<u>Title</u>	<u>Date</u>
/s/ ROBERT ANNUNZIATA Robert Annunziata	Chairman of the Board of Directors, President and Chief Executive Officer	March 6, 1998
/s/ JOHN A. SCARPATI John A. Scarpati	Senior Vice President and Chief Financial Officer (Principal Financial Officer)	March 6, 1998
/s/ MARIA TERRANOVA-EVANS Maria Terranova-Evans	Vice President and Controller (Principal Accounting Officer)	March 6, 1998
/s/ BRENDAN R. CLOUSTON Brendan R. Clouston	Director	March 6, 1998
/s/ JOHN R. DILLON John R. Dillon	Director	March 6, 1998
/s/ GERALD W. GAINES Gerald W. Gaines	Director	March 6, 1998
/s/ JIMMY W. HAYES Jimmy W. Hayes	Director	March 6, 1998

**TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES**

**NOTES TO FINANCIAL STATEMENTS—(Continued)**

**YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995**

**13. Selected Quarterly Information (Unaudited)**

Summarized below is quarterly financial information for the years ended December 31, 1997 and 1996 (in thousands, except per share amounts):

<u>1997</u>	<u>1st Quarter Consolidated</u>	<u>2nd Quarter Consolidated</u>	<u>3rd Quarter Consolidated</u>	<u>4th Quarter Consolidated</u>	<u>Total</u>
Revenues .....	\$ 96,844	\$115,664	\$131,406	\$150,390	\$ 494,304
Net loss .....	(45,028)	(51,332)	(53,784)	(72,523)	(222,667)
Loss per common share ....	\$ (0.28)	\$ (0.31)	\$ (0.33)	\$ (.42)	\$ (1.34)
<u>1996</u>	<u>Combined</u>	<u>Combined</u>	<u>Consolidated</u>	<u>Consolidated</u>	<u>Total</u>
Revenues .....	\$ 50,435	\$ 57,087	\$ 72,749	\$ 87,398	\$ 267,669
Net loss .....	(18,693)	(19,743)	(33,705)	(42,709)	(114,850)
Loss per common share ....	\$ (0.25)	\$ (0.27)	\$ (0.21)	\$ (0.27)	\$ (1.00)

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

**Common Stock.** The complaint further alleges that the actions of the TCG directors, officers and Cable Stockholders in connection with the AT&T Merger constitute a breach of various duties owed to the stockholders of TCG Class A Common Stock. The plaintiffs seek to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages and fees in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiff as the class representative.

Plaintiffs' counsel in the above three putative stockholder class action proceedings have agreed (i) to defer the obligation of the defendants to answer the actions and (ii) to consolidate the actions by filing an amended consolidated complaint. As of the end of February 1998, the amended consolidated complaint had not been filed. The Company believes that these proceedings, individually and in the aggregate, are without merit and that any associated costs will not have a material adverse effect on TCG's financial condition, results of operations or cash flows.

In the ordinary course of business, TCG is involved in various litigation and regulatory matters, proceedings and claims. In the opinion of TCG's management, after consultation with counsel, the outcome of such proceedings will not have a materially adverse effect on TCG's financial position, results of operations or cash flows.

#### 12. Supplemental Disclosure of Cash Flow Information

Cash paid for interest and non-cash investing and financing activities for the years ended December 31, 1997, 1996 and 1995 were as follows (in thousands):

	1997	1996	1995
Cash paid during the year for interest .....	\$ 43,008	\$ 7,818	\$ 8,675
Fixed assets acquired under capital leases .....	\$ 38,244	\$ 14,034	\$ 15,151
Compensation paid in stock .....	\$ 4,772	—	—
Rights-of-way obtained in exchange for cable installation .....	\$ —	\$ —	\$ 1,330
Conversion of subordinated debt to parents plus accrued interest .....	\$ —	\$ 263,602	\$ —
Conversion and stock split of \$1 par value common stock to 139,250,370 shares of Class B Common Stock as part of the TCG Reorganization .....	\$ —	\$ 213,099	\$ —
Acquisition of subsidiaries .....	\$ 131,246	\$ —	\$ —
Cash acquired in acquisitions .....	1,203	—	—
Common stock issued .....	123,334	—	—
	124,537	—	—
Cash paid to acquire subsidiaries .....	\$ 6,709	\$ —	\$ —

**TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS—(Continued)**  
**YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995**

*Revenue Sharing Agreements*

Teleport Communications is subject to a revenue sharing agreement with The Port Authority of New York and New Jersey (the "Port Authority"). Based on the agreement, Teleport Communications is obligated to pay to the Port Authority 5% of its gross revenues, and may be required to pay a "net return rental fee," as defined, to the extent its cumulative net return exceeds the entitlement amount. For the years ended December 31, 1997, 1996 and 1995 the payments made were \$300,000 in each year. Teleport Communications is required to remit to the Port Authority a minimum payment currently equal to \$300,000 annually.

Teleport Communications entered into a 15-year franchise agreement with the City of New York during 1994, which among other things, requires a payment based on certain gross revenues, as defined in the agreement. The franchise provides for the payment of 10% of certain gross revenues in 1995 and 1996, 6% in 1997 and 5% thereafter, all subject to certain setoffs, reductions and adjustments. The franchise also provides that commencing with calendar year 1995, payment to the City will be no less than \$200,000 per year. For the years ended December 31, 1997, 1996 and 1995 the payments made to the City under the franchise were \$1.1 million, \$0.8 million and \$0.3 million, respectively.

*Litigation*

In April 1997, a complaint seeking damages in an unspecified amount was filed against the Company in the Circuit Court of Cook County, Illinois by two former customers of the Company and an alleged class purporting to consist of investors in one of the customers, alleging fraud and breach of contract. The initial complaint was dismissed in September 1997 and an amended complaint was refiled by the plaintiffs in October 1997. The Company, upon consultation with counsel, believes that the allegations are without merit and that it possess meritorious counterclaims for damages arising from breach of contract. The Company additionally believes that any costs arising from this lawsuit will not have a material adverse effect on its financial condition, results of operations or cash flows.

On December 16, 1997, prior to public announcement of the AT&T Merger, an action was filed by one TCG public stockholder in the Delaware Court of Chancery against TCG, TCG's directors and the Cable Stockholders. The plaintiff's complaint alleges that, based on public reports, TCG's directors, management and controlling stockholders were negotiating the sale of TCG to AT&T on a preferential basis. This sale on a preferential basis, the complaint alleges, would offer little or no premium over the current market price of TCG Class A Common Stock and is therefore unfair and inadequate to TCG's public stockholders. The plaintiff seeks to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiff as the class representative.

On January 12, 1998, an action was filed by two TCG public stockholders in the Delaware Court of Chancery against TCG, certain TCG directors and officers, the Cable Stockholders and AT&T. The complaint alleges that the exchange ratio in the AT&T Merger represents an inadequate premium for stockholders of TCG Class A Common Stock. The complaint further alleges that the actions of the TCG directors, officers and Cable Stockholders in connection with the AT&T Merger constitute a breach of various fiduciary duties owed to the stockholders of TCG Class A Common Stock. The plaintiffs seek to enjoin the merger of TCG and AT&T or, alternatively, to rescind the transaction and/or recover damages in the event that the transaction is consummated. The complaint seeks to have the action certified for class action status and to appoint the plaintiffs as the class representatives.

On January 28, 1998, an action was filed by a TCG public stockholder in the Delaware Court of Chancery against TCG, certain TCG directors and officers, and the Cable Stockholders. The complaint alleges that the exchange ratio in the AT&T Merger represents an inadequate premium for stockholders of TCG Class A

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

certain scheduled increases and for possible escalation of basic rentals based on a change in the cost of living or on other factors. TCG expects to enter into other contracts for additional franchise fees, office rents, node rents, rights-of-way, facilities, equipment, and maintenance services in the future.

A summary of such fixed commitments at December 31, 1997 is as follows (in thousands):

<u>Years</u>	<u>Amount</u>
1998.....	\$ 34,079
1999.....	32,286
2000.....	29,986
2001.....	27,908
2002.....	25,723
Thereafter .....	65,814
Total .....	<u>\$215,796</u>

Rent expense under operating leases was approximately \$31.4 million, \$18.0 million and \$11.8 million for the years ended December 31, 1997, 1996 and 1995, respectively.

#### *Capital Leases*

Communications network includes assets acquired under capital leases of approximately \$154.1 million and \$114.1 million (including approximately \$111.6 million and \$96.0 million with related parties) at December 31, 1997, and 1996, respectively. The related accumulated depreciation and amortization was approximately \$18.9 million and \$12.1 million, respectively.

The following is a schedule, by year, of future minimum payments under the leases, together with the present value of the net minimum payments as of December 31, 1997 (in thousands):

<u>Years</u>	<u>Amount</u>
1998.....	\$38,218
1999.....	12,545
2000.....	4,860
2001.....	844
2002.....	534
Thereafter .....	4,130
Total minimum lease payments .....	61,131
Less amount representing interest .....	8,312
Total obligations under capital leases .....	<u>\$52,819</u>

#### *Retention Incentive*

As part of the AT&T Merger, TCG has offered a retention incentive compensation package to all employees as of January 8, 1998. These amounts are payable in four installments, the closing date of the proposed AT&T Merger, the first anniversary of the closing date, the second anniversary of the closing date and thereafter to all employees still employed at TCG. Such amounts are currently estimated at \$14.4 million, \$14.4 million, \$10.4 million and \$.8 million, respectively. There are no assurances that the AT&T Merger will be consummated.



## TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

##### 10. Related Party Transactions

In 1996 TCG entered into a preliminary agreement with TCI which provided for the provision of certain services by TCG to TCI in connection with the development by TCI of residential telephony service offerings in Hartford, Connecticut, San Francisco, California and Arlington Heights, Illinois and possibly other locations. TCI has agreed to reimburse TCG for certain costs and cost of capital in connection with these services. TCG is also in the process of negotiating a market based agreement for the provision of telephony services for TCI in multiple dwelling units at various locations. TCI and TCG are continuing negotiations to reach a definitive agreement for both offerings. At December 31, 1997 and 1996, the amounts due to TCG for this reimbursement were \$1.0 million and \$1.1 million, respectively, and are included in accounts receivable—related parties. TCG has entered into an agreement with Comcast to support a Comcast residential service offering to be conducted in Maryland and Florida.

TCG also provides management services to certain affiliates of Cox under three Operator Managed Ventures Services Agreements, including billing services, network monitoring and accounts receivable functions. Under the terms of the agreements, TCG retains 8% of the collected revenues from Cox customers as a royalty fee. Royalty fees recorded from Cox were approximately \$0.6 million, \$0.3 million and \$0.1 million for the years ended December 31, 1997, 1996 and 1995, respectively. Included in accounts receivable—trade are approximately \$1.0 million and \$0.4 million at December 31, 1997 and 1996, respectively, for amounts owed by Cox customers. At December 31, 1997 and 1996, the amounts due to Cox affiliates under the agreements were \$1.7 million and \$1.1 million, respectively.

In 1997 and 1996, TCG purchased cable on behalf of certain of the Cable Stockholders, which it then sold to them at cost. The amount receivable from the owners was \$1.1 million and \$1.5 million as of December 31, 1997 and 1996, respectively.

Sprint Spectrum, a partnership owned 60% by TCI, Comcast and Cox, entered into preliminary agreements or letters of intent with a number of wholly-owned subsidiaries of TCG providing for the construction of special facilities and the provision of services to Sprint Spectrum by TCG. TCG and Sprint Spectrum have continued this service relationship throughout 1997. The amount receivable from Sprint Spectrum at December 31, 1997 and 1996, respectively, was \$1.6 million and \$0.3 million.

In connection with the management of the Local Market Partnerships, TCG entered into management services agreements. Under the terms of such agreements, TCG provided certain operating and administrative services to such entities, for which it earned management fees. Management fees earned were approximately \$0.2 million, \$21.8 million and \$29.6 million in 1997, 1996 and 1995, respectively. After July 2, 1996, such management fee revenue is no longer recorded because the previously unconsolidated partnerships are now consolidated.

Related to the acquisition of KCFN, TCG is liable to fund the operations until the closing. Such liability for KCFN as of December 31, 1997 is \$2.3 million which is included in accounts payable and accrued liabilities. The liability associated with the acquisition of KCFN of approximately \$55 million is included in accounts payable and accrued liabilities.

##### 11. Commitments and Contingencies

###### *Operating Leases*

Under the terms of contracts with various parties, TCG is obligated to pay franchise fees, office rents, node rents and rights-of-way fees in connection with its fiber optic network through 2022. These contracts provide for

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

certain employee whose minimum annual bonus is 50% of base salary. Each executive is entitled to these severance benefits for at least six months following such termination, except for a certain employee whose minimum entitlement period is 30 months.

#### 9. Income Taxes

There are no current income taxes payable based on TCG's operating loss. The current state and local tax expense are based on factors other than income. The following temporary differences compose the net deferred income tax payable (in thousands):

	1997	1996
Deferred income tax liabilities:		
Depreciation, amortization and excess credits	\$ 73,868	\$ 43,072
Other	553	—
	<u>74,421</u>	<u>43,072</u>
Deferred income tax assets:		
Operating loss	(192,433)	(81,578)
Deferred revenue	(2,403)	(2,361)
Assets recorded for tax purposes	(3,575)	(3,368)
Incentive compensation	(6,434)	(4,579)
Equity in losses of unconsolidated subsidiaries	(142)	(138)
Other	(248)	—
	<u>(205,235)</u>	<u>(92,024)</u>
Less: valuation allowance	131,778	49,874
Total deferred tax assets	<u>(73,457)</u>	<u>(42,150)</u>
Deferred income taxes payable—net	<u>\$ 964</u>	<u>\$ 922</u>

In 1997, 1996 and 1995, the net income tax benefits of approximately \$81.9 million, \$29.6 million and \$10.9 million, respectively, have been offset by increases in the valuation allowance of \$81.9 million, \$29.6 million and \$10.9 million, respectively, due to the uncertainty of realizing the benefit of the loss carry-forwards.

At December 31, 1997, TCG had operating loss carry-forwards for federal income tax purposes of approximately \$523.0 million, expiring principally in 2003 through 2013. Approximately \$49.0 million of the net operating loss carryforwards are carryovers related to the acquisitions of BizTel and ETC. The net operating losses related to these acquisitions will be subject to various limitations.

A reconciliation of the statutory federal income tax rate and TCG's effective income tax rate is as follows:

	1997	1996	1995
Statutory federal income tax rate	35.00%	35.00%	35.00%
State and local taxes, less federal benefit	0.75	2.36	1.30
Unutilized tax benefit due to net operating loss	(30.04)	(31.80)	(33.30)
Permanent differences and other	(4.96)	(3.20)	(1.70)
Effective rate	<u>0.75%</u>	<u>2.36%</u>	<u>1.30%</u>

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

Company's common stock in which to monitor stock price volatility. Had TCG adopted SFAS No. 123, net loss and loss per share would have increased as indicated below (in thousands, except share amounts):

	1997	1996	1995
Net loss—as reported .....	\$ (222,667)	\$ (114,850)	\$ (53,804)
Net loss—pro forma .....	\$ (225,625)	\$ (116,398)	\$ (53,929)
Loss per share—as reported .....	\$ (1.34)	\$ (1.00)	\$ (0.77)
Loss per share—pro forma .....	\$ (1.36)	\$ (1.02)	\$ (0.77)
Weighted average number of shares outstanding ...	165,728,059	114,443,695	70,000,140

*Valuation Assumptions*—The fair value of options at the date of grant was established using the Black-Scholes model with the following weighted average input assumptions:

	Expected Life	Exercise Price	Stock Price at Grant	Volatility	Risk Free Int. Rate	Div. Yield	Annual Forfeiture Rate
1996 Employee Stock Purchase Plan Grants .....	1.00	\$13.60	\$16.00	25.0%	5.81%	0%	4.89%
1995, 1996 and 1997 Stock Option Grants .....	5.00 to 7.00	\$14.22 to \$46.98	\$14.22 to \$46.98	0.1% to 26.4%	5.80% to 6.73%	0%	0% to 5.00%

The following table summarizes information concerning the remaining options outstanding as of December 31, 1997 for the 1997, 1996 and 1995 option grants and the 1997 Employee Stock Purchase Plan:

	Options Outstanding				Options Exercisable	
	Range of Exercise Prices	Number of Shares Outstanding	Weighted Avg. Remaining Contractual Life	Weighted Average Exercise Prices	Number of Shares Exercisable	Weighted Average Exercise Prices
1995, 1996 and 1997 Stock Option Grants and 1997 Employee Stock Purchase Plan .....	\$14.22 to \$55.02	4,011,154	5.00 to 7.00	\$14.22 to \$46.98	2,313	\$14.22

*Employment Agreements*—TCG has employment agreements with certain of its executive officers and senior management personnel. These agreements are effective through dates ending from June 30, 1998 to December 31, 2000, unless terminated earlier by the executive or TCG, and provide for annual salaries, cost-of-living adjustments, additional compensation in the form of bonuses based on the performance of TCG and the executive, and participation in the various benefit plans of TCG. The agreements contain certain benefits to the executive if TCG terminates the executive's employment without cause or if the executive terminates his employment as a result of change in ownership of TCG. The salary and bonus expense related to these employment agreements for the years ended December 31, 1997, 1996 and 1995 approximated \$3.6 million, \$2.9 million and \$2.1 million, respectively. TCG's remaining aggregate commitments for salaries under such agreements is approximately \$4.9 million. The commitments for bonuses under these agreements is approximately \$1.9 million.

In the event TCG terminates the executive without cause or the executive terminates his/her employment as a result of a change in control, the agreements provide for continued vesting in deferred compensation and long term incentive awards as well as the payment of a base salary for each executive plus an annual bonus for the duration of the agreement. The annual bonus is an amount not less than 30% of such base salary, except for a

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

employee was given an option to purchase a number of shares of Class A Common Stock up to 10% of such employee's compensation plus bonus paid for the calendar year preceding the year the option is awarded, divided by the purchase price per share under the option. No employee can receive options for more than \$25,000 worth of shares in any calendar year. The purchase price for one share of Class A Common Stock is 15% below the initial offering price of \$16, or \$13.60. The Board of Directors has authorized the issuance of 745,000 shares under the 1996 Stock Purchase Plan. The options expired on June 27, 1997. Options related to 584,686 shares of Class A Common Stock were exercised.

The expense recorded in each of the years ended December 31, 1997 and 1996 related to the options issued was approximately \$0.7 million.

The following table provides additional information concerning the 1996 and 1997 Employee Stock Purchase Plans:

	Shares of Common Stock		Exercise Price
	Available for Grant	Outstanding	
Balance, January 1, 1996	—	—	\$ —
Authorized	745,000	—	13.60
Granted	(623,894)	623,894	13.60
Exercised	—	—	—
Forfeited	41,001	(41,001)	13.60
Balance, December 31, 1996	162,107	582,893	\$ 13.60
Authorized	1,500,000	—	—
Granted	(109,975)	109,975	35.54
Exercised	—	(609,651)	13.60—35.54
Forfeited	83,217	(83,217)	13.60
Balance, December 31, 1997	1,635,349	—	\$ —

*Stock-Based Compensation*—In October 1995, the FASB issued SFAS No. 123, "Accounting for Stock-Based Compensation" which encourages but does not require companies to record compensation cost for stock-based compensation plans at fair value.

TCG has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion ("APB") No. 25 "Accounting for Stock Issued to Employees," and its related interpretations. Accordingly, no compensation expense has been recorded for its stock awards and employee stock purchase plans, but rather, the Company has determined the pro forma net loss and net loss per share amounts for 1997, 1996 and 1995, as if compensation expense had been recorded for options granted during those years under the fair value method described in SFAS No. 123. Compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. Compensation cost for stock appreciation rights and performance equity units is recorded quarterly based on the quoted market price of TCG's stock at the end of the period.

The Company utilized the Black-Scholes option pricing model to estimate the fair value at the date of grant of options granted during 1997, 1996 and 1995. Under the Black-Scholes model, the volatility factor ranged from 25.0% to 26.4% was used for options granted on or after the date of the 1996 Offerings and the minimum value method was used for options granted prior to the date of the 1996 Offerings, as if there was no market for the

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

of the Compensation Committee, which has made long-term incentive compensation awards in the form of non-qualified and incentive stock options to eligible employees. Stock options were granted with exercise prices at or above the fair market value of the shares on the date of grant, and no compensation expense has been recognized in connection with the options. The Compensation Committee may permit the exercise price to be paid in cash, through delivery of other shares of Class A Common Stock, by delivering irrevocable instructions to a financial institution to deliver promptly to TCG the portion of sale or loan proceeds sufficient to pay the exercise price, or through an election to have shares withheld from the shares otherwise to be received by the option holder.

The following table provides additional information concerning the SOP:

	Shares of Common Stock		Exercise Price
	Available for Grant	Outstanding	
Balance, January 1, 1995 .....	2,888,046	2,495,304	\$ 6.90—10.39
Authorized .....	—	—	—
Granted .....	(285,096)	285,096	14.22
Exercised .....	—	(27,115)	6.90
Forfeited .....	215,225	(215,225)	6.90—14.22
Balance, December 31, 1995 .....	2,818,175	2,538,060	\$ 6.90—14.22
Authorized .....	5,547,683	—	—
Granted .....	(2,003,462)	2,003,462	17.46—21.60
Exercised .....	—	(55,355)	6.90
Forfeited .....	173,443	(173,443)	6.90—21.60
Balance, December 31, 1996 .....	6,535,839	4,312,724	\$ 6.90—21.60
Authorized .....	—	—	—
Granted .....	(1,935,068)	1,935,068	24.48—55.02
Exercised .....	—	(285,332)	6.90—10.39
Forfeited .....	155,944	(155,944)	6.90—49.00
Balance, December 31, 1997 .....	4,756,715	5,806,516	\$ 6.90—55.02

*Teleport Communications Group Inc. Employee Stock Purchase Plan (1997)*—TCG adopted the Teleport Communications Group Inc. Employee Stock Purchase Plan (the "1997 Stock Purchase Plan"), effective July 1, 1997. The 1997 Stock Purchase Plan is administered by the Compensation Committee of the Board of Directors (the "Committee"). As of the first day of each calendar quarter each eligible employee will be granted the option to purchase as of the last day of each calendar quarter, a number of shares determined under a uniform formula specified by the Committee. Each eligible employee was given an option to purchase the number of shares equal to 10% of such employee's compensation plus bonus paid in that calendar quarter, divided by the purchase price per share under the option. No employee can receive options for more than \$25,000 worth of shares in any calendar year. The purchase price for one share of Class A Common Stock is 15% below the average closing price of the last ten trading days of the calendar quarter. The Committee authorized the issuance of 1,500,000 shares of Class A Common Stock under the 1997 Stock Purchase Plan. The expense recorded for the year ended December 31, 1997 related to options issued was approximately \$0.3 million.

*Teleport Communications Group Inc. Employee Stock Purchase Plan (1996)*—TCG adopted the Teleport Communications Group Inc. Employee Stock Purchase Plan (the "1996 Stock Purchase Plan"), effective June 27, 1996. The 1996 Stock Purchase Plan is administered by the Committee. Each eligible

# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

## NOTES TO FINANCIAL STATEMENTS—(Continued)

### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

The following table provides additional information concerning the Unit Appreciation Plan awards:

Year of Award	Initial Number of Units	Number of Units Outstanding at December 31, 1997	Number of Units Vested at December 31, 1997	Value of Units Vested at December 31, 1997	Number of Units Outstanding at December 31, 1996	Number of Units Vested at December 31, 1996	Value of Units Vested at December 31, 1996	Number of Units Outstanding at December 31, 1995
1993 .....	36,000	5,300	5,300	\$369,410	5,300	4,240	\$ 295,528	23,700
1992 .....	170,850	—	—	—	63,250	63,250	7,695,373	139,200
Total .....	206,850	5,300	5,300	\$369,410	68,550	67,490	\$7,990,901	162,900

*Teleport Communications Group Inc. 1996 Equity Incentive Plan*—TCG established the Teleport Communications Group Inc. 1996 Equity Incentive Plan (the "Equity Incentive Plan") effective June 27, 1996, to provide opportunities for certain employees of TCG to participate in the appreciation in the value of TCG after the initial public offering. The Board of Directors authorized the issuance of up to 637,792 shares of Class A Common Stock under the Equity Incentive Plan. The Equity Incentive Plan is administered by the Compensation Committee which has full and discretionary power to award shares under the Equity Incentive Plan.

Under the Equity Incentive Plan, each employee who had an award under the 1992 UAP or the 1993 UAP, whether or not the employee had elected to defer receipt of the payment of benefits thereunder and who is employed by TCG as of June 27, 1996, had the right to waive his/her interest in all or any portion of the employee's benefit in the 1992 UAP or the 1993 UAP. In exchange therefore, the employee was granted a number of shares under the Equity Incentive Plan equal to the value of the portion of the employee's benefit waived (determined as of June 27, 1996) multiplied by 120% and divided by the initial public offering price per share of Class A Common Stock. No employee could receive more than 54,000 shares under the Equity Incentive Plan, and a certain employee was not eligible to participate. One share under the Equity Incentive Plan is equivalent in value to one share of Class A Common Stock. Thus, the value of the benefit payable under the Equity Incentive Plan will fluctuate in accordance with the fair market value of the Class A Common Stock.

Shares under the Equity Incentive Plan granted in exchange for 1992 UAP benefits are subject to a two-year vesting schedule, with 70% of the shares becoming vested as of June 27, 1997 and the remaining 30% becoming vested as of the June 27, 1998. Shares granted in exchange for the 1993 UAP benefits are subject to a three-year vesting schedule, with 70% of the shares becoming vested as of June 27, 1998 and the remaining 30% becoming vested as of June 27, 1999. A participant shall become 100% vested in his/her shares in the event of death, total disability or a change in control. In the event a participant's employment is terminated for cause, his/her interest in each and every share awarded under the Equity Incentive Plan shall be forfeited.

Shares under the Equity Incentive Plan will be paid to a participant either in one lump sum cash payment or in shares of Class A Common Stock, as determined at the discretion of the Compensation Committee, on the payment date elected by the participant at the time he/she elects to participate in the Equity Incentive Plan. In general, the payment date elected may be the last business day of any calendar quarter during the period commencing June 30, 1998 and ending June 30, 2001.

At December 31, 1997 and 1996, respectively, 409,983 and 421,233 shares were outstanding under the Equity Incentive Plan.

*Teleport Communications Group Inc. Stock Option Plan*—TCG established the Teleport Communications Group Stock Option Plan (the "SOP") effective September 26, 1993. The SOP is administered at the discretion

## TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

to the Company from its sale of shares pursuant to the 1997 Equity Offering were approximately \$317.4 million, after deducting the underwriting discount and expenses of approximately \$11.3 million.

#### 8. Employee Benefit Plans

*Teleport Communications Group Retirement Savings Plan*—TCG has a Retirement Savings Plan (the "Plan") with a retirement savings component covering substantially all eligible employees of TCG with one or more years of service and a 401(k) savings component covering substantially all eligible employees of TCG. Under the retirement component of the Plan, TCG contributes an amount based on years of service and annual eligible compensation. Under the 401(k) component of the Plan, participants may make pre-tax contributions and TCG matches 50% of the first 6% of annual eligible compensation to a maximum company contribution of \$1,500 per employee for employees with more than one year of service. Participants with less than one year of service may make pre-tax contributions without a company match.

Effective November 1, 1996, the Plan offers TCG's Class A Common Stock as an investment option. The Plan purchases shares on the open market. As of December 31, 1997 and 1996, respectively, 113,553 and 36,186 shares, with a total market value of \$6.2 million and \$1.1 million, had been purchased under the Plan.

In 1997, 1996 and 1995, TCG made matching contributions of \$1.5 million, \$1.1 million, and \$0.7 million, respectively, as required by the 401(k) component and \$2.2 million, \$1.4 million, and \$1.0 million, respectively, under the retirement component of the plan.

TCG has established a non-qualified, funded, deferred compensation Make-Up Plan of Teleport Communications Group Inc. (the "Make-Up Plan") for the Teleport Communications Group Inc. Retirement Savings Plan. The purpose of the Make-Up Plan is to provide certain eligible participants benefits which would have been payable under the Retirement Savings Plan, but were limited by the maximum company match of \$1,500, as well as compensation limits set forth by the IRS. Expenses incurred in connection with the Make-Up Plan were approximately \$0.9 million in 1997 and were insignificant in 1996 and 1995.

*Teleport Communications Group Unit Appreciation Plan*—TCG has established the Teleport Communications Group Unit Appreciation Plan (the "UAP") for 1992 and 1993. During the years ended December 31, 1993 and 1992, TCG made awards of deferred compensation in the form of units (the "Units"), pursuant to the UAP, to certain eligible employees of TCG. Benefits under the UAP are equal to the value of the Units on the date the employee terminates employment or is fully vested in the Units, less the initial base price of the Units. The initial base price of each Unit as of January 1, 1993 and 1992 was \$34.85 and \$30.00, respectively. Each Unit is equal to 8.4 shares of Class A Common Stock. Except for awards to a certain employee, the appreciation of any Unit is limited to 200% of the initial base price. Pursuant to an employee's employment agreement, there is no limit on the appreciation he may receive under the 1992 UAPs. Awards under the UAP are subject to a five-year vesting schedule, pursuant to which the Units granted were 60% vested as of December 31, 1995 and December 31, 1994, respectively, and fully vested no later than December 31, 1997 and December 31, 1996, respectively, subject to certain exceptions provided therein. The 1992 UAPs were fully vested December 31, 1996 and were paid early in 1997. In connection with the UAP, TCG recognized compensation expense of \$15 thousand, \$1.4 million and \$2.5 million for the years ended December 31, 1997, 1996 and 1995, respectively. In January 1996, TCG adopted a plan which permits the awards under the UAP to be deferred in whole or in part at the election of the participants for periods of up to five years or, with the Administrative Committee's consent, until termination of employment.

## TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

### NOTES TO FINANCIAL STATEMENTS—(Continued)

#### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

##### *Cable Stockholders Loan Agreement*

TCG had a loan agreement with the Cable Stockholders aggregating \$349.6 million (\$269.0 million outstanding at December 31, 1995). Borrowings bore interest at 75 basis points above the one-month London Interbank Offered Rate ("LIBOR"). Total interest expense for this loan was \$0, \$8.4 million and \$17.6 million for the years ended December 31, 1997, 1996 and 1995, respectively.

##### *ETC Facility*

In the acquisition of ETC, TCG assumed ETC's credit facility which was entered into in October 1995 with CoreStates Bank, N.A. and certain other lenders (the "ETC Facility"). The ETC Facility is a \$60.0 million credit facility. The ETC Facility provides for interest based upon either the base rate, or LIBOR, adjusted as defined in the ETC Facility (7.4375% at December 31, 1997), which is payable quarterly. The balance outstanding is due on September 30, 1998. Borrowings under the ETC Facility are collateralized by substantially all of the assets and outstanding common stock of TCG Delaware Valley, Inc. In addition, the ETC Facility contains certain restrictive covenants which, among other things, require TCG Delaware Valley to maintain certain debt service coverage ratios and limit the payment of dividends and capital expenditures. TCG is currently in compliance with terms of these covenants. In addition, TCG Delaware Valley is required to pay .375% per year on the available portion of the ETC Facility. The total outstanding balance at December 31, 1997, was \$52.6 million.

#### **7. Stockholders' Equity**

##### *1997 Equity Offering*

Continental acquired its interest in TCG in May 1993. On November 15, 1996, Continental was acquired by U S WEST. In connection with such acquisition, on November 5, 1996, the U.S. Department of Justice announced, and on February 28, 1997, a final judgment was entered (the "Final Judgment") with respect to a settlement with U S WEST and Continental pursuant to which Continental was required to reduce its ownership in TCG below 10% by June 30, 1997, and was required to eliminate such ownership entirely by December 31, 1998. On February 19, 1997, pursuant to the Amended and Restated Stockholders' Agreement dated June 26, 1996, between TCG and the Cable Stockholders (the "Amended Stockholders' Agreement"), Continental converted 4,000,000 shares of Class B Common Stock into 4,000,000 shares of Class A Common Stock and, in accordance with the provisions of Rule 144 promulgated by the Commission under the Securities Act, transferred these shares to one or more third parties. Thereafter, Continental converted an additional 4,500,000 shares of Class B Common Stock, pursuant to the Amended Stockholders' Agreement, and in accordance with the provisions of Rule 144 transferred 3,840,000 of such shares to one or more third parties.

TCG filed a registration statement for a public offering (the "1997 Equity Offering") of 17,250,000 shares of Class A Common Stock on October 10, 1997, and the 1997 Offering was consummated on November 13, 1997. Of the 17,250,000 shares, 7,304,408 were offered by the Company and 9,945,592 shares were offered by Continental. The Company did not receive any proceeds from the sale of shares by Continental. The net proceeds



# TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

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### YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

The commitment will be reduced in equal quarterly installments according to the following schedule:

<u>Year</u>	<u>Amount</u> (in millions)
2000 .....	\$ 12.5
2001 .....	35.0
2002 .....	55.0
2003 .....	70.0
2004 .....	90.0
2005 .....	100.0
2006 .....	37.5
	<u>\$400.0</u>

The shares of capital stock owned by TCG in certain of the wholly-owned subsidiaries of TCG (TC New York Holdings I, Inc., TC New York Holdings II, Inc., TCG Payphones, Inc., and TC Systems, Inc., collectively the "Restricted Subsidiaries") were and remain pledged as collateral to secure loans pursuant to, and may not be pledged to any other party under the terms of, the Revolving Credit Agreement.

In December 1995, the capital stock of the wholly-owned Restricted Subsidiaries of TCG was transferred, subject to the pledge, to TCG New York, Inc., a wholly-owned subsidiary of TCG. TCG New York, Inc. assumed all obligations under the Revolving Credit Agreement as of the date of transfer. TCG New York, Inc. is permitted under the terms of the Revolving Credit Agreement to advance funds to TCG. When made, such advances are to be evidenced by notes from TCG to TCG New York, Inc. which will be pledged as collateral under the Revolving Credit Agreement.

The Revolving Credit Agreement contains various covenants and conditions, including restrictions on additional indebtedness, maintenance of certain financial ratios and limitations on capital expenditures. TCG is currently in compliance with the terms of these covenants. None of these covenants negatively impact TCG's liquidity or capital resources at this time.

In 1995, TCG entered into interest rate swap agreements to mitigate the impact of changes in interest rates on its long-term bank debt. TCG had no interest rate swaps with commercial banks at December 31, 1997 and 1996. The average fixed interest rate was 5.93% in 1995. These agreements effectively fixed TCG's interest rate exposure on various LIBOR based floating rate notes (which ranged from 5.87% to 5.94%). During July 1996, TCG repaid \$250 million of bank indebtedness with the proceeds of the 1996 Offerings. Due to this repayment, TCG is not currently required under its Revolving Credit Agreement to enter into interest rate swap arrangements. Accordingly, during 1996, TCG terminated four interest rate swap arrangements which were due to mature in 1997, for a gain of approximately \$1.5 million.

#### *TCI Subordinated Note*

In connection with the 1996 Offerings, the Cable Stockholders contributed to TCG \$269.0 million aggregate principal amount of indebtedness, plus accrued interest from May 1995, except that TCI retained a \$26 million subordinated note of TCG, in exchange for Class B Common Stock issued to the Cable Stockholders. The loan agreement was terminated in connection with the TCG Reorganization. Interest and principal on the TCI Subordinated Note were payable in 2001. The TCI Subordinated note was repaid on December 31, 1997 at a discounted value of approximately \$25.1 million.